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FM AMCONSUL SHANGHAI
TO RUEHC/SECSTATE WASHDC 7082
INFO RUEHBJ/AMEMBASSY BEIJING 2043
RUEHGZ/AMCONSUL GUANGZHOU 1314
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SUBJECT: CASH MEETS CAPITAL: UNDERGROUND FINANCING IN WENZHOU

11. (SBU) Summary: On August 12, Econoff visited the entrepreneurial city of Wenzhou, Zhejiang Province to discuss challenges facing small and medium size enterprises (SMEs). Interlocutors noted several difficulties brought on by the current economic slowdown. In particular, SMEs have been disproportionately affected by government credit tightening policies, which have been stepped up recently over concerns about inflation. Underground ("private") lending has helped make up for some of the financing shortages faced by SMEs in the current credit tight environment, but government interlocutors in Wenzhou posit that actual underground lending may be much less than has been reported in the media. Although the local government is adopting several measures to increase "official" financing channels for SMEs, such as licensing small-sum loan companies, local government contacts believe that these measures will not play a significant role in China's capital markets when credit policies are loosened at some point in the future. End Summary.

Challenges Facing SMEs

12. (SBU) In separate meetings with Econoff on August 12, Cai Lingyue, Vice President of the People's Bank of China (PBOC) Wenzhou Branch, and Pan Pingping, Deputy Director of the Wenzhou Bureau of Foreign Trade and Economic Cooperation (BOFTEC), discussed challenges faced by small and medium size enterprises (SMEs). These challenges include financing, rising costs of labor and raw materials, RMB appreciation, and value added tax (VAT) rebate adjustments. Although Pan acknowledged that some SMEs in Wenzhou are closing down, he downplayed media reports of mass closures as "exaggerated," stating it is "natural" for businesses to open and close based on fluctuations in the economy.

13. (SBU) In terms of financing, Cai and Pan both noted SMEs have been disproportionately affected by government credit tightening policies, which have been stepped up recently over concerns about inflation. SMEs account for more than 65 percent of total value added of industry in China according to Chinese Banking Regulatory Commission (CBRC) statistics; however, these data show that SMEs receive only 30 percent of corporate loans.

In Wenzhou, the concentration of small and medium enterprises is higher than the national average, accounting for roughly 80 percent of value added, by Cai's estimate. In the current environment, it has become increasingly difficult for these enterprises to secure adequate financing, as loans to SMEs are on average considered riskier than loans to larger firms. With required reserve ratios at 17.5 percent and restrictions placed on loan growth, commercial banks lend first to their safer clients, usually large firms which have more assets to use as collateral.

PBOC Devising New Financing Channels for SMEs

14. (SBU) Based on SMEs' contributions to Wenzhou's economy, PBOC/Wenzhou's Cai believes it is the PBOC's "responsibility" to develop policies and institutions to aid SMEs. Cai said PBOC is encouraging the Postal Savings Bank of China, rural banks, small loan companies, and other small financial institutions to meet SME financing needs. Cai also noted the PBOC is actively promoting the development of intermediary markets, notably loan retailers to direct loans to SMEs, and is also working with small financial institutions to help improve risk management. He added that the recent PBOC decision to increase loan quotas by 5 percent and 10 percent for the five main national banks and local banks respectively is aimed primarily to help SMEs, small farms and rural industries.

Underground Lending Provides Some Relief

15. (SBU) According to Cai, the primary financing channels for
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Wenzhou SMEs include bank loans, direct financing or trust loans, underground lending (loans made outside of officially sanctioned channels) and loans from other financial institutions such as credit unions, pawn shops and collateral companies. Though bank loans are still the primary source of capital for SMEs, underground lending has also played a significant role in covering SMEs' capital shortages. Although Cai believes private lending has its advantages, he emphasized its risks, notably its lack of transparency and undermining of Central Government macro-control policies. He also downplayed its weight, claiming it accounts for 10 percent of current total lending in Wenzhou as opposed to 30 to 40 percent in the 1980s.

Who Has the Right Numbers?

16. (SBU) The newspaper Wen Weipo, citing experts familiar with underground lending, reported the practice could account for up to 30 percent of all lending in China. Likewise, a University of International Business and Economics (UIBE) Professor estimates underground lending accounts for 25 percent of all lending activity. Comment: Given the relatively high concentration of privately owned SMEs in Wenzhou and suspicion that most underground financing goes to SMEs, Cai's estimate that 10 percent of total lending in Wenzhou is from private lending suggests (though anecdotally) that the actual amount of capital in underground financial markets may be considerably smaller. End Comment.

17. (SBU) Cai said the Wenzhou PBOC has chosen over 600 sites in rural and suburban areas from which it monitors local lending rates and the flow of private capital, including to which industries the capital is flowing. The data is collected by the PBOC's own local staff based in different counties across Wenzhou. From this data, he estimates current monthly (non-annualized) private interest rates to be roughly 3 to 4 percent, though there are reports of monthly interest rates reaching 8 percent or higher for some very short term loans.

Small-Sum Loan Companies only Temporary Solution

¶8. (SBU) In May 2008, the CBRC and PBOC jointly promulgated the "Guiding Opinions on the Pilot Operation of Small-Sum Loan Companies" delegating authority to provincial governments to issue guidelines and grant licenses to small-sum loan companies, with the express purpose of helping SMEs find financing. Zhejiang Province is the first province to have issued regulations and to begin granting licenses. Cai said this is part of the government's effort to develop financial intermediary markets, helping to connect entrepreneurs and investors, and increasing the overall efficiency of China's capital markets.

¶9. (SBU) Sixteen licenses already have been granted in Wenzhou under heavy competition. In order to obtain one of these licenses (as established by Zhejiang regulators), companies must have more than 50 million RMB in net assets and have recorded profits for three straight years with total profits exceeding 15 million RMB. In less developed areas the restrictions are slightly relaxed, requiring only 20 million RMB of net assets and 6 million RMB of total profit. Asset liability ratios are not allowed to exceed 70 percent. Cai expects that interest rates for small-sum loan companies will not be over four times the benchmark interest rate determined by the PBOC.

¶10. (SBU) Cai and Wenzhou BOFTEC's Pan expressed skepticism over the efficacy of these small-sum loan companies in easing the overall credit-tight environment. Pan noted the companies can only raise capital from investors, ensuring they would remain secondary to commercial banks which raise capital through deposits as well as from investors. Cai likewise did not see a prominent role for small-sum loan companies in China's financial system, noting they would likely fade even further into the

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background when credit policies are relaxed at some future date. He hopes such efforts nevertheless will help bring capital out of the underground market.

Comment

¶11. (SBU) One unintended consequence of China's credit tightening policies is the disproportionate burden placed on SMEs. Underground financing has arisen to relieve some of the burden, but estimates of its true extent are few and of questionable accuracy. PBOC/Wenzhou Cai's estimate that 10 percent of financing in Wenzhou comes from underground lending casts doubt on other estimates that suggest underground lending nationally accounts for 25 to 30 percent. This also raises questions over the ability of the underground financial system to meet the financing needs of struggling SMEs. Small-sum loan companies have been discussed as another possible solution for helping resolve financing difficulties faced by SMEs, though interlocutors did not see them as having much effect beyond temporarily improving intermediary financial markets. This suggests the government is still unwilling to allow any serious alternative to the major state-owned banks, even at the expense of the most productive actors in the economy.
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